

**THE PUBLIC SERVICE COMMISSION
OF SOUTH CAROLINA**

DOCKET NO. 2018-257-WS

IN RE: Application of Kiawah Island Utility,)	DIRECT TESTIMONY
Inc. for Adjustment of Rates and)	
Charges and Modifications to Certain)	OF
Terms and Conditions for the Provision)	
of Water and Sewer Service)	KIRK MICHAEL

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Kirk Michael. My business address is 12535 Reed Road, Sugar Land,
3 Texas.

4 **Q. WHAT IS YOUR CURRENT POSITION?**

5 A. I am employed by SouthWest Water Company ("SouthWest") as Chief Financial
6 Officer and Treasurer; I also serve as Chief Financial Officer and Treasurer for Kiawah
7 Island Utility, Inc. ("KIU"). In this role, I am responsible for the following functions
8 within SouthWest and KIU: strategic planning, capital structure, treasury/cash
9 management, accounting, financial reporting, facilities, and information technology.

10 **Q. PLEASE STATE YOUR EDUCATIONAL AND PROFESSIONAL**
11 **BACKGROUND.**

12 A. My educational background consists of a Bachelor of Science from the United States
13 Naval Academy and a Master's in Business Administration from the University of
14 Houston. I have been employed by SouthWest for 5 years. My professional background
15 prior to being employed by SouthWest includes over 35 years of technical, operational,
16 commercial and financial experience with regulated investor and private equity owned

1 electric utilities and natural gas pipelines, including 15 years as the Chief Financial
2 Officer in five of those companies, E3 Greentech Enterprises, an energy management
3 software startup; Indianapolis Power & Light Company, a vertically integrated power
4 utility; Globeleq, a developer and owner of power generation and distribution
5 companies in the emerging markets; GEXA Energy, a retail electric provider in the
6 unregulated power sector in Texas; and Duke Energy Services, the unregulated division
7 of Duke Energy Corporation which included unregulated power generation (domestic
8 and international), energy services, and engineering/environmental services
9 companies. Prior to beginning my career in the private sector, I served for six years as
10 a nuclear trained submarine officer in the U. S. Navy.

11 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

12 A. The purpose of my testimony is to describe KIU's requested capital structure and
13 interest expense.

14 **Q. WHAT CAPITAL STRUCTURE WAS USED IN KIU'S PREVIOUS GENERAL**
15 **RATE CASE TO CALCULATE KIU'S INTEREST EXPENSE?**

16 A. A debt-to-equity ratio of 51:49 was used to calculate KIU's interest expense in its last
17 rate case. This capital structure was based on KIU as a standalone entity with third-
18 party debt at year-end 2015, including a construction loan due in 2019 that was used
19 for the construction of a second pipeline. The construction loan had a variable short-
20 term interest rate, which had an increasing trend.

1 **Q. HAS KIU’S CAPITAL STRUCTURE CHANGED SINCE ITS LAST GENERAL**
2 **RATE CASE? PLEASE EXPLAIN.**

3 A. Yes. In 2016, as a result of SouthWest’s acquisition of KIU, the amount of equity
4 increased on KIU’s balance sheet due to goodwill associated with the acquisition. At
5 year-end 2016, KIU’s debt-to-equity ratio was reduced to 37:63 reflecting the increase
6 in equity and no change in debt. In 2017, SouthWest paid down KIU’s short-term
7 construction loan from \$14.2 million to \$155,000 as an interim step in the refinancing
8 process undertaken by SouthWest and subsequently completed in May 2018. The
9 offset to the pay-down of the construction loan was an intercompany liability between
10 KIU and SouthWest. Reducing KIU’s outstanding third-party debt also allowed it to
11 negotiate the elimination of its previously required external audit requirement, resulting
12 in savings of approximately \$25,000 per year that are reflected in this rate proceeding.
13 As of the end of the 2017 test year, KIU’s capital structure reflected a debt-to-equity
14 ratio of 35:65 with almost the entire amount of debt being intercompany.

15 In 2018, SouthWest completed a recapitalization/refinancing of most of its debt,
16 including debt incurred for KIU, through a parallel intercompany note. The refinancing
17 of KIU’s debt by SouthWest secured long-term financing on favorable terms that KIU
18 could not have secured as a standalone entity. After SouthWest’s refinancing and
19 completion of the related long-term intercompany note between SouthWest and KIU,
20 the debt-to-equity ratio of KIU was returned to the target capital structure at
21 approximately 50:50 (including the intercompany note).

1 **Q. WHAT CAPITAL STRUCTURE IS KIU REQUESTING BE USED TO**
2 **CALCULATE ITS INTEREST EXPENSE IN THIS CASE? PLEASE**
3 **EXPLAIN.**

4 A. In its Application, KIU requested the use of an imputed 50:50 capital structure. This
5 ratio represents a conservative approximation of (1) the actual KIU capital structure
6 approved by the Commission in KIU's last rate case, (2) the actual capital structure of
7 KIU at year-end 2018 after the refinancing at SouthWest (including the long-term
8 intercompany note put in place in June 2018), and (3) a hypothetical capital structure
9 that has previously been recognized by the Commission as reasonable for other water
10 utilities.

11 **Q. PLEASE DESCRIBE SOUTHWEST'S DEBT REFINANCING THAT WAS**
12 **COMPLETED IN 2018.**

13 A. As stated above, SouthWest conducted a recapitalization/refinancing of most of its
14 long-term debt in 2018. The new issuances of debt consisted of eight tranches of
15 private placement notes totaling \$250 million which were each competitively bid to
16 seven potential lenders. One of the tranches was designated for KIU, a new 30-year
17 note with a principal amount of \$20 million. Utility best practices prescribe that KIU's
18 capital structure should include both equity and debt, and the term of its long-term debt
19 should generally be consistent with the remaining life of its assets. As the average
20 remaining life of KIU's assets is approximately 30 years, SouthWest chose to obtain
21 matching long-term financing for KIU assets with a term-to-maturity of 30 years.

1 Besides meeting best practice guidelines, issuing debt with a term of 30 years also
2 minimizes refinancing risk in the short-to-medium term.

3 It is also best practice to minimize interest rate risk. KIU previously held debt
4 at a floating interest rate indexed to short-term interest rates (represented by LIBOR).
5 In early 2018, the financial markets offered the opportunity to finance new long-term
6 debt at historically low fixed rates. With forecasts of rising floating interest rates, it was
7 to KIU's benefit to obtain new fixed rate debt, to minimize interest rate risk, and lock
8 in an excellent rate. Additionally, KIU benefitted by participating in a larger
9 recapitalization of SouthWest, which allowed KIU to take advantage of its parent's
10 strong credit quality (rated 'BBB+ with a stable outlook' by S&P) and larger scale to
11 obtain better pricing than it could on its own.

12 Therefore, during the refinancing transaction, the 30-year tranche was
13 designated specifically for KIU, which subsequently borrowed the principal from
14 SouthWest as set forth in an intercompany note. The interest rate of SouthWest's new
15 30-year note and the intercompany note from KIU to SouthWest is a fixed rate of
16 4.57%, with matching principal amount of \$20 million. This interest rate is less than
17 what KIU could have obtained independently in financial markets if not part of
18 SouthWest's larger refinancing.

19 **Q. WHAT INTEREST RATE WAS USED TO CALCULATE KIU'S INTEREST**
20 **EXPENSE? PLEASE EXPLAIN.**

21 A. The interest rate used by KIU to calculate interest expense is 4.57%, which is the rate
22 obtained by SouthWest for the 30-year tranche of new notes; and the rate included in

1 the intercompany note between SouthWest and KIU on June 30, 2018, shortly after
2 SouthWest completed its debt refinancing (discussed below). Applying the 50:50
3 capital structure and 4.57% interest rate to KIU's rate base of \$22,108,658 results in
4 the interest expense included in the filing of \$505,183.

5 **Q. WHAT IS THE OPERATING MARGIN REQUESTED IN KIU'S**
6 **APPLICATION?**

7 A. KIU's requested rate increase results in an operating margin of 14.5%. This operating
8 margin is aligned with operating margins recently granted by the Commission, and it
9 is justified by KIU's excellent record of safe and reliable operations, environmental
10 compliance, and customer service.

11 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

12 A. Yes, it does.